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SUBJECT: AFGHANISTAN BANKING SECTOR VULNERABILITIES: EXPOSURE TO DUBAI'S COLLAPSING PROPERTY MARKET AND THE ROLE OF LOTTERY ACCOUNTS

KABUL 00000551 001.2 OF 003

¶1. (C) Summary. The Treasury Attache Office in Afghanistan has met with multiple bank officials, financial sector experts, and a Washington Post reporter in recent weeks to discuss growing rumors that Kabul Bank and Azizi Bank are highly exposed to the Dubai property market. Together, Kabul Bank and Azizi Bank make up a large share of the deposit holdings in Afghanistan. A failure of either bank would have a significant negative impact on the development of the country's economy, in turn severely undermining the U.S. Mission's goals in Afghanistan. The Treasury Attache's Office also discussed the use of lottery deposit accounts with officials from both Azizi Bank and Kabul Bank. End Summary.

Kabul Bank: Rapid Expansion; Exposure to Dubai;
Questions on Liquidity; Relations with Iranian Banks
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¶2. (SBU) Kabul Bank is by far the largest bank in Afghanistan and its wealth has increased dramatically in recent years. Starting from an initial investment of $5 million in 2004, the bank now has assets of $981 million (as of November 2009). The bank is owned by Sher Khan Farnood, a former hawaladar and international poker player, and operated by Khalilullah Frozi (Frozi is not considered a competent banker but is widely respected as an effective - and ruthless - businessman). Mahmood Karzai, the brother of President Karzai, is a shareholder in the bank and is on the bank's board.

¶3. (SBU) Kabul Bank will expand considerably in 2010, starting with a plan to open up 36 branches and extension counters, and 250 low cost container-based branches (which will focus on salary disbursement for government employees). Kabul Bank will also be the first Afghan-owned bank to expand beyond the country's borders when it opens a new branch in Tajikistan this year - a first step in a long term plan to expand into broader Central Asia (Kabul Bank has plans to eventually expand into Uzbekistan, and CEO Frozi is an Uzbeki). In addition, the bank has recently completed negotiations with MasterCard to develop pre-paid cards and credit cards. Other ongoing initiatives include developing a program for the U.S. Military to use prepaid cards as a funding mechanism for Afghan National Security Force (ANSF) soldiers. There are also plans for Afghan Wireless (AWCC) to supply telecommunications and internet services for new Kabul Bank branches and SIM-based account numbers for Kabul Bank employees - a precursor to a broader mobile banking initiative. Finally, the bank is building a massive new multi-million headquarters in Kabul's financial district featuring three office towers encased in bullet-proof glass (the tallest of which is 23 stories), three underground parking garages, a waterfall, and a rotating restaurant on the top floor. The building is expected to be completed in mid-2011.

¶4. (C) On January 23, the Attache Office met with Andy Higgins, a journalist from the Washington Post, who is researching an article about Afghan banks' exposure to the collapse of the Dubai property market. Higgins stated that most of Kabul Bank's 16 shareholders have multiple property holdings in Dubai (Farnood alone has 16 properties there). Based on property purchase records, Higgins calculates Kabul Bank shareholders hold $150 million worth of property in Dubai (with Farnood alone holding $100 million worth). However, Higgins'

contacts in Dubai believe Kabul Bank's exposure is much higher - possibly around $300 million. Kabul Bank officials did not deny Farnood's large investments in Dubai. However, they emphasize that these investments are 'projects' rather than 'property' and that Farnood used money from his other businesses in Dubai rather than Kabul Bank to fund the investments. The officials also stated that the front-end profit on these investments has been substantial.

¶5. (C) Higgins told the Treasury Attache Office that he did not know when the article would be completed but that he would notify the Office in advance of its publication. Depending on the severity of the article, its publication could significantly shake the public's confidence in the Afghan financial sector and lead to backlash from international coalition partners.

¶6. (SBU) Official balance sheet statistics acquired from DAB show that Kabul Bank is the least liquid bank operating in Afghanistan, by almost any measure (less liquid even than troubled, state-owned Pashtany Bank). Kabul Bank's ratio of loans to assets, which indicates the percentage of a bank's assets tied up in loans, is the worst in Afghanistan at 69.2% (the median value for all Afghan banks is 42.4%) and its ratio of liquid assets to short-term liabilities is 20.5%, compared to a median of 51.6% for all Afghan banks. The strain on liquidity may explain recent complaints about Kabul Bank's poor customer service. Multiple sources have told the Treasury Attache Office that Kabul Bank frequently takes more than two days to process withdrawals and has delayed paying government employee salaries by two weeks in order to place those funds in overnight accounts to collect interest. Kabul Bank's high deposit rate reflects its high demand for liquidity: Kabul Bank pays 6-7.5% on deposits, compared to the 1.5% rate paid by AIB.

¶7. (C) In recent meetings with the Treasury Attache, Kabul Bank officials broached the topic of their involvement with Iranian banks. The officials stated their desire to finance legitimate commercial

trade between Iran and Afghanistan without jeopardizing relations with either U.S. or Afghan authorities. (Note: Officially, Afghanistan imported $200 million of merchandise from Iran in FY2008/09, representing 6% of Afghanistan's total imports. However, much of the trade between Afghanistan and Iran is unrecorded and Kabul Bank officials estimate that $3 billion worth of goods is traded between the contries. In addition, goods flowing between Western Afghanistan and the rest of the world often transit through the Iranian port, Bander Abbas). Kabul Bank opened a correspondent relationship with Iran's Post Bank in September 2009 and has had a correspondent account with the Export Development Bank of Iran (EDBI) for several years. Kabul Bank uses both relationships to help facilitate letters of credit for transactions between Afghan and Iranian businesses. Kabul Bank officials hoped that it would be possible for Afghan banks to continue to transfer funds to and from banks in Iran, as long as necessary documentation is provided.

Azizi Bank: Questionable Investments and Potential Overexpansion

¶8. (SBU) There are many similarities between Kabul Bank and Azizi Bank and these similarities have produced animosity between the two institutions. Azizi Bank is the third largest bank in Afghanistan, with assets of $322 million. The bank was founded in June 2005 by Chairman Mirwais Azizi (possibly the richest man in Afghanistan) and Vice Chairman Ali Akbar Zahwandai, a former hawaladar. Azizi Bank presently has 57 branches in Afghanistan - 24 in Kabul and 33 in the provinces. Like Kabul Bank, Azizi Bank is planning a massive branch expansion in 2010, including opening 16 new branches in Kabul and 45 in provinces. (NOTE: Azizi and Kabul Bank are racing to establish branch presence in the provinces, mainly to obtain contracts with the Afghan government to handle employee payments). Also like Kabul Bank, Azizi Bank is in negotiations with MasterCard to create pre-paid cards and debit cards and is working to expand its reach in mobile banking via a recent agreement with Roshan Communications (which operates the much ballyhooed 'M-Paisa' project).

¶9. (C) Azizi Bank is also highly exposed to Dubai. Washington Post

journalist Higgins obtained property records showing that Azizi Bank had purchased $120 million worth of land in the Palm Jebel Ali at the height of the Dubai property market in mid 2008 (the Palm Jebel Ali is a man-made island project designed to accommodate 1.7 million people and originally set for completion in 2020). Construction on the project has since halted due to the collapse of the local property market. Dubai financial sector insiders suspect Azizi Bank has many more investments in Dubai beyond the Palm Jebel Ali, and Higgins claims that Mirwais Azizi has hired a team of lawyers to cover up Azizi Bank's existing property records in Dubai.

¶10. (SBU) Industry insiders believe that Azizi Bank lost money in the last quarter of 2009 due mainly to exposure in Dubai, branch overexpansion, and the bank's incorporation of the failed Development Bank of Afghanistan (DBA). In early 2009, Azizi Bank purchased DBA, which had been placed under conservatorship by the Central Bank for detected fraud and troubled assets. Azizi Bank committed itself to pay 100% of all of DBA's individual and public depositors, and restarted operations with the new name of Bakhtar Bank. Azizi Bank's rapid expansion in 2009 also likely reduced its profits, as new bank branches in Afghanistan typically run at a loss for 1-2 years as they build their deposit base.

Banks Ignore Governor Fitrat's Order to Eliminate Lottery Accounts

¶11. (SBU) Both Azizi Bank and Kabul Bank use lottery accounts (Azizi Bank uses the term Qismat, which means 'luck' in Dari, while Kabul Bank uses the term Bakht, which means 'fortune'). For every $100 deposited in a lottery account, the depositor is given a ticket in a lucky draw held every month for a cash prize. Kabul Bank is now giving away a $1 million yearly prize and smaller amounts in monthly prizes. Azizi Bank pays out in a similar fashion, though in smaller amounts. Banks profit immensely from lottery accounts because they do not pay interest on the deposits. Kabul Bank officials claim that 33% of their total deposits ($289 million) are in Bakht accounts and that this share is growing. Azizi Bank's share of Qismat accounts has fallen significantly in recent years: at the end of 2009, 22% of the bank's total deposits were in Qismat accounts, compared to 35% in ¶2007.

¶12. (C) Central Bank Governor Fitrat has twice issued regulatory circulars to banks in Afghanistan requiring them to phase out lottery accounts (once in 2008 and again in late 2009). However, bankers have ignored the command, indicating Governor Fitrat's lack of political authority. According to Andy Higgins, Kabul Bank CEO Frozi said that he has no intention of following Governor Fitrat's orders, stating 'if Bakht accounts go, so will the Karzai government.

Comment

¶13. (SBU) We see lottery accounts as taking advantage of Afghans who lack financial savvy. The expected value of putting money in a lottery account (i.e. the amount of the cash prize offered times the chance of winning the prize) is much less than the expected value of a normal interest-bearing deposit account. However, there is also a danger in quickly phasing out lottery accounts, as the money in those accounts may not stay in the formal financial sector. The Treasury Attache office has not taken a strong stand on this issue. While we sympathize with Governor Fitrat's dislike for the scheme, we feel that a quick end to lottery accounts would lead to a significant drop in deposits in the formal financial system.

¶14. (C) We also have concerns about Kabul Bank's confrontational approach to banking in Afghanistan. Kabul Bank officials have repeatedly stated their desire to 'crush' or 'destroy' other banks in Afghanistan, particularly Bank Azizi. This Winner-Take-All mentality goes beyond healthy competition and risks undermining cooperation in the Afghan financial sector. It may also be destabilizing. Central Bank Governor Fitrat has shared similar concerns with the Embassy and has accused Kabul Bank officials of trying to undermine his own regulatory policies by bribing and threatening officials within the

Karzai government. While the U.S. Mission should not limit legitimate competitive practices, we should look to instill more balance in the Afghan banking sector. USG agencies and our international partners should do business with a broad share of Afghan banks rather than relying on Kabul Bank simply because it is the largest bank in Afghanistan (Note: Currently Afghanistan International Bank [AIB] handles financing for most USG transactions in Afghanistan, but the USG-AIB contract will expire soon and Kabul Bank has put in a serious bid to take it over. The Treasury Attache has raised concerns about this issue with Deputy Commander USFOR-A Major General John Macdonald).

¶15. (SBU) The exposure of major Afghan banks to the Dubai property market and the risk of bank overexpansion are causes for concern. Afghanistan has yet to develop a 'strong banking culture' and most Afghans still depend on the informal sector (mainly hawalas) to conduct financial transactions. A failure of a major bank in Afghanistan would be a significant setback for Afghanistan's financial sector and its domestic economy more broadly. Afghanistan's small banks are particularly vulnerable to a loss of public confidence in the formal financial sector, as they rely more heavily on small depositors.

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